FEDERAL INCOME TAX REFORM: A REVIEW OF TWO PROPOSALS

Staff Working Paper

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INTRODUCTION

The federal income tax system has been the subject of much discussion recently, in part because it has been the subject of much dissatisfaction. Several Members of Congress have introduced proposals for income tax reform that attempt to correct a variety of flaws in the system. Two widely discussed reform proposals--S. 1472/H.R. 3271 introduced jointly by Senator Bill Bradley and Representative Richard Gephardt, and S. 2948/H.R. 6165 introduced jointly by Senator Robert Kasten and Representative Jack Kemp--would modify the existing tax by broadening its base and lowering its rates.1/

This paper outlines problems of the current system, describes the major provisions of both bills and the differences between them, and analyzes some of the consequences that might arise in switching to a "modified flat" tax system such as the ones being proposed.

SHORTCOMINGS OF THE CURRENT SYSTEM

Critics of the current tax system have expressed concern about:

- its special provisions, which contribute to perceptions about the tax system's unfairness and complexity;
- its narrow base, which makes it difficult to generate adequate revenue even at high marginal rates that discourage work effort, investment, and saving; and
- its partiality toward certain kinds of activities (such as consumption and particular types of investment), which unduly influences economic decisions.

Fairness and Complexity

A recent survey conducted by the Advisory Commission on Intergovernmental Relations concluded that taxpayers believe the federal income tax to be the least fair tax they pay.2/ This perception has developed during a period when the number of special provisions in the tax code has increased rapidly. In 1970, 53 tax expenditures

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1. S. 1472/H.R. 3271 is commonly referred to as the Bradley-Gephardt plan. S. 2948/H.R 6165 is known as the Kemp-Kasten plan. Some information on the two plans was provided by members of the Senators' and the Representatives' staffs.

2. Advisory Commission on Intergovernmental Relations. Changing Public Attitudes on Governments and Taxes (Washington, D.C., ACIR, 1983).

were recognized; by 1982, the Congress had eliminated six of these but added 29 new ones.3/ This large number of special provisions has contributed to the view that some taxpayers receive more favorable treatment than others.

The large number of tax preferences also has necessarily complicated the tax code. Each year more and more taxpayers rely on professional tax specialists to calculate their tax liabilities and to prepare their tax returns. For tax year 1982, 40 percent of all returns were prepared by professional tax services.4/

The complexity of the tax system has little effect on the majority of tax filers, however. In 1982, the most recent year for which tax data are available, roughly two-thirds of all tax filers did not claim itemized deductions and almost 40 percent used a short form. These shares for 1982 have not changed significantly since the late 1970s.

The Tax Base

In recent years, the federal income tax base has declined as a share of personal income. Table 1 shows that adjusted gross income (AGI) reported on tax returns has gradually fallen from about 80 percent of personal income in 1950 to about 70 percent in 1982.

A variety of tax preferences account for most of this erosion of the tax base. Foremost among them are nontaxed employer-paid fringe benefits. Employers' contributions for private pensions, health insurance, and other supplements to wages and salaries rose from 2.5 percent of wages and salaries in 1950 to 10 percent in 1982.

Another reduction in the base is unreported income. Data on unreported income are difficult to obtain, but evidence from the Internal Revenue Service (IRS) suggests that "underground" activities account for an increasing portion of aggregate income. A 1983 IRS study estimated that the uncollected amount of income taxes owed nearly tripled between 1973 and 1981, reaching more than $90 billion by 1981. A decline in the percentage of certain personal income sources voluntarily reported (notably capital gains, royalties, and dividends) was largely responsible for this

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3. Congressional Budget Office, Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986 (1981), and Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1984-1988 (1983). As a result of changes in classification, 104 tax expenditures were recognized in 1982.

4. Internal Revenue Service, "Individual Income Tax Returns: Selected Characteristics from the 1982 Taxpayer Usage Study," SOI Bulletin, vol. 3, no. 1 (Summer 1983).

TABLE I. ADJUSTED GROSS INCOME (In billions of dollars and as a percent of personal income)

Calendar Year	Adjusted Gross Income	As a Percent of Personal Income
1950	179.1	79.2
1960	315.5	78.9
1970	631.7	78.8
1980	1,613.7	74.5
1982	1,847.8	71.7

SOURCE: "Personal and Adjusted Gross Income," Survey of Current Business, November 1981, April 1983, and April 1984. Also "Federal Personal Income Taxes: Liabilities and Payments," Survey of Current Business, May 1978, March 1980, and April 1984.

NOTE: Personal income includes wages and salaries, transfer payments and other nontaxable compensation, personal interest income, personal dividend income, rental income, and proprietors' income. It excludes personal contributions to social insurance programs.

increase.[5] A factor offsetting erosion of the tax base is the decline in the aggregate income of households that make too little money to be subject to the income tax. The failure of the standard deduction and personal exemptions to keep pace with the inflation rate and with nominal wage growth is largely responsible for this decline.

Tax Rates

As the tax base has narrowed, marginal tax rates faced by most taxpayers have increased. Over time the tax structure has become more compressed; the width of the tax brackets has not increased to compensate for inflation and real growth in income. As a result, taxpayers at the same relative position in the income distribution have been moved into higher tax brackets. For example, Table 2 shows that more than 20 percent of taxpayers faced marginal rates above 30 percent in 1982, compared with only 2.5 percent in 1967.

This upward drift in marginal tax rates was offset somewhat by the statutory tax rate reductions of the past three years, which reduced marginal tax rates across the board by approximately 23 percent and cut the top rate from 70 percent to 50 percent. Even with these tax rate cuts fully phased in, however, the share of

5. Internal Revenue Service, Income Tax Compliance Research: Estimates for 1973-1981 (July 1983).

taxpayers facing high marginal tax rates is much higher than in the 1960s. For example, a family of four with the median income using the standard deduction would have faced a marginal tax rate of 19 percent under 1967 law, compared with 22 percent under 1984 law. A similar family with twice the median income had a marginal tax rate of 25 percent under 1967 law but 38 percent under 1984 law.

Distortions

Numerous features of the tax code result in uneven taxation among different saving and investing activities. Such unequal treatment distorts saving and investing decisions, thus affecting both the overall level and the form of investment.

Under current law, some corporate income is taxed twice--once at the corporate level and again when distributed to shareholders as dividends. This discourages investment in corporations and encourages debt over equity financing. Other investment income such as interest on state and local government bonds, imputed returns on owner-occupied housing, 60 percent of realized long-term capital gains, and returns to pension fund holdings is not taxed at all. Such exemption from tax provides substantial motivation to hold capital in these and other tax-preferred forms.

TABLE 2. DISTRIBUTION OF MARGINAL TAX RATES, 1967 AND 1982

Marginal Tax Rate (Percent)	Number of Taxable Returns		Percent of Taxable Returns	
	1967	1982	1967	1982
12 - 15	12,146,185	12,158,317	20.62	15.33
16 - 20	32,552,548	24,512,217	55.25	30.90
21 - 25	11,686,482	17,635,234	19.84	22.23
26 - 30	1,065,342	8,841,150	1.81	11.14
31 - 40	939,129	12,708,000	1.59	16.02
41 - 50	364,921	3,474,674	0.62	4.38
51 - 70	163,837	0	0.28	0.00
Total	**58,918,444**	**79,329,592**	**100.00**	**100.00**

SOURCE: Department of the Treasury, Internal Revenue Service, Statistics of Income--1967, Individual Income Tax Returns (1969); and Department of Treasury, Internal Revenue Service, "Advance Data: 1982 Individual Income Tax Returns" (December 1983).

The tax code allows full deductibility of all interest payments. Thus, in inflationary times the code does not distinguish between the real return to capital and the "inflation premium" intended to compensate lenders for the decline in the value of the principal. Borrowers benefit at such times by being permitted to deduct both of these components of interest. When investors in high tax brackets hold tax-preferred investments that are financed by issuing taxable debt to tax-exempt and low-tax-bracket investors, tax liabilities are reduced, thereby encouraging debt-financed investments generally and investments in owner-occupied housing in particular (since the imputed return is not taxed).

The Economic Recovery Tax Act of 1981 (ERTA) increased investment incentives considerably, mainly by liberalizing business depreciation. The Accelerated Cost Recovery System (ACRS) provides more generous depreciation allowances for business equipment and structures, as well as increased investment tax credits for purchases of equipment. This reduces significantly the user cost of capital and encourages investment in depreciable business assets. Two subsequent tax measures (the Tax Equity and Fiscal Responsibility Act of 1982, and the Tax Reform Act of 1984) have reduced the very large tax benefits of ACRS somewhat, but substantial investment incentives remain.

The tax-based incentives to invest are not equal for all assets, however, and tax treatment of new investment still varies considerably. While overall effective tax rates on business assets have fallen substantially, the effective rates on equipment remain lower than those on structures, which may encourage a disproportionately high level of investment in equipment relative to structures. Effective tax rates on depreciable assets also vary greatly by industry. Table 3 shows estimated 1982 effective tax rates, by industry, on new investment in depreciable assets. The furniture manufacturing industry, for example, faced a 29 percent tax rate while the rate on investments made by the air transportation industry was less than one-half as large (11 percent).

PROPOSED REFORMS

The two alternative tax systems proposed by Senator Bradley and Representative Gephardt and by Senator Kasten and Representative Kemp are similar in many respects. Both would retain separate income taxes for individuals and corporations, broaden the bases of the income taxes by eliminating many tax preferences, and reduce the number of brackets and lower marginal tax rates. Major differences exist in the treatment of capital gains and losses, the allowable write-offs for depreciable business assets, and the effects of inflation on the tax system. Each plan is described below, and the effects of major provisions are compared with those of current tax law in Table 4.

Individual Income Taxes

The Bradley-Gephardt Plan. This plan would enact a tax system with a substantially different rate and bracket structure. It would apply a basic rate of 14 percent to all taxable income and then add two surtaxes: 12 percent on adjusted gross

TABLE 3. ESTIMATED EFFECTIVE TAX RATES ON NEW INVESTMENT IN DEPRECIABLE ASSETS, BY INDUSTRY, 1982 (In percents)

Industry Number	Category	Tax Rate
1.	Food and kindred products	27.0
2.	Tobacco manufactures	24.3
3.	Textile mill products	22.8
4.	Apparel and other fabricated textile products	25.3
5.	Paper and allied products	18.3
6.	Printing, publishing, and allied industries	28.1
7.	Chemicals and allied products	20.1
8.	Petroleum and coal products	33.2
9.	Rubber and miscellaneous plastic products	19.8
10.	Leather and leather products	27.4
11.	Lumber and wood products, except furniture	25.3
12.	Furniture and fixtures	28.6
13.	Stone, clay, and glass products	24.6
14.	Primary metal industries	26.0
15.	Fabricated metal industries	23.3
16.	Machinery except electrical	24.6
17.	Electrical machinery, equipment, and supplies	24.7
18.	Transportation equipment, except motor vehicles and ordnance	30.4
19.	Motor vehicles and motor vehicle equipment	21.3
20.	Professional photographic equipment and watches	27.0
21.	Miscellaneous manufacturing industries	25.8
22.	Agricultural production	16.8
23.	Agricultural services, horticultural services, forestry, and fisheries	14.7
24.	Metal mining	34.3
25.	Coal mining	19.1
26.	Crude petroleum and natural gas extraction	32.2
27.	Nonmetallic mining and quarrying, except fuel	15.6
28.	Construction	13.1
29.	Railroads and railway express service	21.4
30.	Street railway, bus lines, and taxicab service	10.0
31.	Trucking service, warehousing, and storage	14.7
32.	Water transportation	6.3
33.	Air transportation	11.5
34.	Pipelines, except natural gas	22.9

(Continued)

Table 3. (Continued)

Industry Number	Category	Tax Rate
35.	Services incidental to transportation	17.1
36.	Telephone, telegraph, and miscellaneous communication services	19.7
37.	Radio broadcasting and television	25.8
38.	Electric utilities	25.0
39.	Gas utilities	20.0
40.	Water supply, sanitary services, and other utilities	39.4
41.	Wholesale trade	18.7
42.	Retail trade	27.5
43.	Finance, insurance, and real estate	37.3
44.	Services	23.9

SOURCE: Alan J. Auerbach, "Corporate Taxation in the United States," Brookings Papers on Economic Activity, 2:1983 (Washington, D.C., The Brookings Institution, 1983), p. 468.

NOTE: These results, though illustrative of the large differences in taxation of depreciable assets among industries, do not show industrywide tax rates on all assets. For example, for crude petroleum and natural gas extraction, the computation does not account for the amount of investment in the form of expensed intangible drilling and development cost. In addition, the calculations assume that all investments are 100 percent equity-financed and that all firms have sufficient tax liability to use fully the investment tax credit and ACRS deductions.

TABLE 4. FACT SHEET ON MAJOR TAX REFORM PROPOSALS

	Current Law	Bradley-Gephardt	Kemp-Kasten
	INDIVIDUAL INCOME TAX		
Tax Rates			
Ordinary Income	11%-50%	14%, 26%, 30%	20%, 28%, 25%[a]
Capital Gains	20% maximum rate	30% maximum rate	18.8%/25%[b]
Alternative Minimum Tax	20%	Repealed	Current law with capital losses included in the minimum tax base
Exemptions			
Taxpayer	$1,000	$1,600	$2,000
Spouse	$1,000	$1,600	$2,000
Dependent	$1,000	$1,000	$2,000
Blind, Aged	$1,000	$1,000	$2,000
Zero Bracket Amount (single/joint)	$2,300/$3,400	$3,000/$6,000	$2,700/$3,500
Indexing	Yes	No	Yes
Income Averaging	Yes	No	No
Taxable Income			
Dividends	$100 excluded	Included	Included
Municipal Bond Interest	Excluded	Interest on public-purpose bonds excluded	Interest on public-purpose bonds excluded
IRA, Keogh Earnings and Earnings on Pension Reserves	Excluded	Excluded	Excluded
Employer Contributions for Health Insurance Plans	Excluded	Included	Excluded
Employer Contributions for Life Insurance Plans	Excluded	Included	Excluded

(Continued)

SOURCE: Congressional Budget Office.

a. The Kemp-Kasten plan would allow a 20 percent employment income exclusion up to the per capita Social Security taxable maximum ($39,300 in 1985). The exclusion would be phased out between $39,300 and $102,200; it would be reduced by 12.5 percent of the excess of wages over $39,300. For taxpayers with labor income of less than $10,000 ($15,000 joint), investment income could be added up to a total exclusion limit of $15,000. This results in marginal tax rates of 20 percent on income up to $39,300; 28 percent on income between $39,300 and $102,200; and 25 percent on income above $102,200.

b. For a transition period of 10 years, the taxpayer would choose between indexing of the capital basis (25% effective rate) and a 25 percent exclusion of the capital gain/loss (18.8% effective rate). If the taxpayer chooses indexing, gains would be taxed in full; a full offset for capital losses would be allowed up to limits that grow to $90,000 by the tenth year and would be unlimited thereafter. Capital loss deduction would be included as a tax preference in the minimum tax base.

TABLE 4. (Continued)

	Current Law	Bradley-Gephardt	Kemp-Kasten
	INDIVIDUAL INCOME TAX (Continued)		
Social Security Benefits (single/joint)	Half benefits taxed if modified AGI over $25,000/$32,000c/	Current law	Include in income benefits over $7,000/$10,500, but not to exceed half of benefits
Unemployment Compensation	Included, depending on other incomed/	Included	Included
Employment Income	Included	Included	20% excludeda/
IRA, Keogh Contributions	Deducted	Current law	Current law
State and Local Taxes			
Income	Deducted	Deducted at 14% rate	Not deducted
Property			
Real	Deducted	Deducted at 14% rate	Deducted
Personal	Deducted	Not deducted	Not deducted
Sales	Deducted	Not deducted	Not deducted
Charitable Contributions	Deducted	Deducted at 14% rate	Deducted
Medical Expenses	Only if more than 5% of AGI	Only if more than 10% of AGI	Only if more than 10% of AGI
Home Mortgage Interest	Deducted	Deducted at 14% rate e/	Deducted
Other Nonbusiness Interest	Deducted	Nonbusiness interest limited to amount offset by net investment income, deductible at 14% rate e/	Only interest on educational loans is deductible
Two-Earner Deduction	10% of earnings of lesser-earning spouse, up to $3,000	Not deducted	Not deducted
Capital Gains	60% excluded	Included	Included, indexedb/
Capital Losses	50% taken against income, up to $3,000	Limited f/	Unlimited, indexedb/
Loss Carryover	Unlimited	One year	One year
Tax Credits			
Earned Income Credit	Yes	Yes	Modified

(Continued)

c. Modified adjusted gross income (AGI) includes AGI plus one-half of the Social Security benefits plus interest on tax-exempt bonds.

d. If AGI plus unemployment compensation exceeds $12,000 for a single return ($18,000 joint return), half of the excess is included in income up to the amount of the benefits.

e. Also deductible up to the limit of net investment income from adjusted gross income for taxpayers who pay the surtax.

f. Limited to capital gains plus the smallest of: taxable income; or $1,500 single ($3,000 joint); or net capital loss. For this purpose, taxable income excludes capital gains, capital losses, and personal exemptions.

TABLE 4. (Continued)

	Current Law	Bradley-Gephardt	Kemp-Kasten
	PROVISIONS AFFECTING BUSINESS (Corporate and Noncorporate)		
Investment Tax Credit	6%-10%	No	No
Intangible Drilling Costs of Oil, Gas, and Geothermal	Expensed	Assigned to 10-year depreciation class	Assigned to 3-year ACRS depreciation class
Treatment of Depletion of Oil, Gas, and Geothermal	Cost depletion for integrated oil companies, percentage depletion for mineral producers and independent oil companies	Assigned to 10-year depreciation class	Assigned to 3-year ACRS depreciation class
R&D Credit	Yes	No	No
Targeted Jobs Tax Credit	Yes	No	No
Rehabilitation Credit	Yes	No	No
Excess Bad Debt Reserves	Yes	No	No
Employee Stock Ownership Plan	Yes	No	No
Depreciation	ACRS	"Open Accounts" based on modified ADR asset lives	ACRS
	CORPORATE INCOME TAX		
Tax Rates			
Regular	15%-40% on first $100,000, 46% thereafter	30%	15% on first $50,000, 30% thereafter
Capital Gains	28%	30%	20%, indexed
Add-On Minimum Tax	15%	Repealed	Current law
Deductions			
Capital Losses	Limited to capital gains	Current law	Indexed; limited to capital gains
Excess Capital Losses	Carryback 3 years, carryforward 5 years	Current law	Current law
Charitable Contributions	Deducted	50% deduction	Deducted

income (AGI) between $40,000 and $65,000 on a joint return (between $25,000 and $37,500 on a single return) and 16 percent on AGI above $65,000 ($37,500). In effect, it would establish a three-bracket system, with marginal tax rates of 14 percent, 26 percent, and 30 percent. The tax structure would not be indexed to counteract the effects of inflation.

The definition of adjusted gross income would be broadened to include many sources of income currently not taxed or not fully taxed. Many fringe benefits such as employer-provided premiums for health and life insurance, which together account for roughly half of all nontaxed fringe benefits, would be counted as taxable income. The largest remaining untaxed fringe benefit is employer-provided pension payments. Under the Bradley-Gephardt plan, the maximum amount per employee that could be set aside each year would be reduced at first by one-third; further reductions in subsequent years would be made through repeal of the indexing of these contribution ceilings. The portion of long-term capital gains now excluded (60 percent) would be included in the tax base. Interest on private-purpose municipal bonds that is now tax exempt would become taxable. The exclusion of contributions to Individual Retirement Accounts (IRAs) and Keogh plans, however, would be retained at currently allowed levels.

A wide range of deductions and credits would be eliminated under this proposal. The plan would repeal the state sales tax deduction, raise the floor on deductible medical expenses to 10 percent of adjusted gross income, and repeal all tax credits except the foreign tax credit and the earned income credit for low-wage earners with children. The dependent care credit would be converted to a deduction.

The Bradley-Gephardt plan would retain certain widely used deductions including those for homeowners' mortgage interest, state and local income and real property taxes, and charitable contributions. It also would preserve the deductibility of interest payments on other borrowing up to the level of net investment income. All allowable itemized deductions would be taken against income in the bottom bracket only. That is, they would be valued at a 14 percent marginal rate, which reduces their generosity for all taxpayers except those now in the lowest tax brackets. This is equivalent to converting all itemized deductions into 14 percent tax credits. Additionally, an above-the-line deduction would be allowed against income subject to the surtaxes for nonbusiness interest up to the limit of investment income.

The amount of income a taxpayer can earn before owing any income tax—the taxpaying threshold—would be higher under the Bradley-Gephardt plan. Currently, a family of four can earn up to $7,400 without being subject to tax. This is the product of a $3,400 zero bracket amount (for joint filers) and four $1,000 personal exemptions. The plan would raise the zero bracket amount to $6,000 and allow a personal exemption of $1,600 each for both taxpayer and spouse and of $1,000 for each dependent. For a family of four, this creates a taxpaying threshold of $11,200.

The Kemp-Kasten Plan. The Kemp-Kasten plan would enact a flat 25 percent tax rate. In practice, though, the Kemp-Kasten marginal tax rates would vary because the plan allows an employment income exclusion of 20 percent. That is, for every dollar of wages and salary earned, up to the Social Security taxable maximum ($39,300 in 1985) 20 cents would be tax exempt, so a 25 percent tax rate levied on the

remaining 80 cents would generate 20 cents in tax for every extra dollar earned. The net effect of the exclusion would be to lower the tax rate for those with incomes in 1985 below $39,300 to 20 percent. The exclusion would be phased out as income increases so that it would be unavailable to those with incomes above $102,200.[6] For incomes between $39,300 and $102.200, a marginal rate of 28 percent would apply. All income above the phase-out range (that is, above $102,200) would face a marginal rate equal to the 25 percent statutory rate. (The employment income exclusion is described in greater detail below.) The Kemp-Kasten rate structure would be indexed annually for inflation.

Like Bradley-Gephardt, this proposal would broaden the income tax base by including in taxable income some items that now are fully or partially tax exempt. All dividend income and interest on private-purpose municipal bonds would become taxable. After a 10-year transition period, all capital gains would be fully taxable and all capital losses would be fully deductible; the capital basis on which a gain or loss is calculated would be indexed for inflation.[7] At current rates of inflation, this would, when fully phased in, lower the capital gains tax on most assets, but would increase the tax on assets with very high rates of return.

Deductions for state income and sales taxes would be repealed, but that for real property taxes would remain. Deductions for home mortgage interest and charitable contributions would still be allowed. Medical expenses could be deducted if they exceeded 10 percent of adjusted gross income. Contributions to retirement savings accounts would remain tax exempt. Social Security benefits above $10,500 on a joint return ($7,000 on a single return) but not exceeding 50 percent of all benefits would be included in taxable income.

The Kemp-Kasten plan would raise the taxpaying threshold for a family of four to $14,375, raising the zero bracket amount to $3,500 and the personal exemption to $2,000 per person. As mentioned above, it would allow an exclusion of 20 percent of employment income (wages and salaries) per earner up to the limit of the Social Security wage base. For taxpayers with employment income of less than $15,000 on a joint return ($10,000 on a single return), income from other sources could be treated as employment income up to a limit of $15,000 for total excludable income. The purpose of the exclusion is to offset partially the Social Security tax.

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6. The 20 percent income exclusion would be phased out in the following way: for each dollar earned above $39,300, the dollar amount of the income exclusion would be reduced by 12.5 percent. The exclusion would be reduced to zero at an income level of $102,200.

7. For a 10-year transition period, Kemp-Kasten would allow a taxpayer to choose between a 25 percent unindexed exclusion of capital gains/losses and an indexed capital basis. After the first 10 years, the capital basis would be indexed and no exclusion would be allowed. Capital gains would be fully taxable. For capital losses, the bill specifies annual limits that grow from $3,000 in the first year to $10,000 in the second year and to $90,000 in the tenth year. After the tenth year, the deduction for losses would be unlimited.

Business Taxes

Both tax plans would repeal many of the special industry provisions currently in effect; neither would integrate the corporate and individual income taxes. Both plans treat business income differently in several respects.

The Bradley-Gephardt Plan. Under this plan, the existing depreciation system would be replaced with a system of allowances intended to reflect more closely economic depreciation by setting up an "open accounts" system based on modified Asset Depreciation Range (ADR) lives.8/ As a result, taxable profits are certain to be higher than under current law. Other things equal, however, a lower tax rate should offset at least some of the higher tax liabilities that might otherwise result.

The effect of this change would differ among industries. In many capital-intensive industries such as manufacturing, it would shorten the depreciation lives of many assets and thereby increase costs of capital. It would extend the lives of assets used in industries such as air transportation, but would not increase significantly costs of capital for labor-intensive or research-and-development-intensive industries or for firms unable to use fully the ACRS deductions allowed under current law.

Capital gains would be subject to ordinary taxation, and most provisions for small corporations, such as graduated tax rates, would be curtailed or eliminated.

Most deductions, credits, and special provisions would be repealed including the investment tax credit, the expensing of intangible drilling costs of oil and gas firms, the percentage depletion allowance, and the research-and-development tax credit. An exception would be a deduction for 50 percent of charitable contributions.

A tax rate of 30 percent would apply to all corporate taxable income.

The Kemp-Kasten Plan. This proposal would retain the ACRS system, thus providing more liberal depreciation allowances than Bradley-Gephardt. Like Bradley-Gephardt, it would repeal the investment tax credit. As with the individual tax, Kemp-Kasten would exclude a portion of capital gains from taxation during a transition period; after 10 years, however, it would tax all capital gains in full on an indexed basis. After a phase-in period, full deduction of capital losses against ordinary income would be allowed (see note 7).

As in Bradley-Gephardt, most special industry provisions would be repealed. A full deduction would be retained for corporate charitable contributions. Expensing of up to $10,000 of new assets would remain.

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8. The Asset Depreciation Range system, in effect before 1981, intended to distribute depreciation deductions over the useful life of each asset. To achieve this, it assigned all depreciable assets to classes that were associated with prescribed asset lives for tax depreciation.

The first $50,000 of taxable corporate income would be subject to a 15 percent rate, and all income above that to a 30 percent tax rate.

ANALYSIS OF THE PROPOSALS

Both the Bradley-Gephardt and the Kemp-Kasten plans are significant departures from current tax law. As such, they could have far-reaching effects on the overall federal tax system, on taxpayers' perceptions and decisions, and on economic activity.

Revenue Neutrality

One important issue is: How much revenue would the alternative income tax systems generate? In setting the same revenue goal as current law, "revenue-neutral" proposals separate the issues of deficit reduction from those of tax reform. In theory, the proposed tax regimes could be easily revised to increase or reduce revenues—by raising or lowering their marginal tax rates.

The concept of revenue neutrality is ambiguous. It can apply to only the individual income tax, to both individual income and corporate income taxes, or to the entire federal tax system. For example, because the proposals adjust the individual and corporate income tax structures by widening the tax base, they could affect the tax base for unemployment insurance, Social Security, and other retirement programs. If fringe benefits were included in taxable compensation for purposes of the income tax, they could also be subjected to payroll taxation. This would result in additional revenue that could be offset by lower payroll tax rates.

Both proposals were designed to be revenue neutral in their first year, although not necessarily according to the same concept. That is, they intend to raise approximately the same amount of revenue as the current law revenue "baseline" projected for the first year of their enactment.9/ The Bradley-Gephardt plan was designed to be neutral with both the individual income and payroll taxes in mind. Because it is not indexed, it would yield more revenue relative to current law in future years than it would in the base year. The Kemp-Kasten plan is intended to be neutral relative to the income tax alone. Currently, CBO is unable to evaluate the revenue effects of these bills and will rely on the Joint Committee on Taxation to prepare estimates of both bills.

Although static revenue estimates provide an important basis for comparison, they do not account for dynamic response to the proposed changes likely to result from major tax reform such as the two plans discussed here. Because the Bradley-

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9. Since S. 1472/H.R. 3271 and S. 2948/H.R. 6165 were designed, the tax law has changed and the revenue baseline has been reestimated. The Tax Reform Act of 1984, signed on July 18, 1984, enacted some of the base-broadening measures included in the two alternative tax proposals. This implies different effects of the proposals relative to 1985 tax law.

Gephardt plan taxes many currently tax-free fringe benefits, it could trigger a change in the composition of compensation. Over time, wages could grow relative to total compensation, partially replacing fringe benefits. In consequence, payroll tax collections would rise in the absence of offsetting changes in law. Likewise, induced changes in work effort could change the composition of the labor force under both plans. Changes in the tax treatment of business assets could lead to a different mix of investment. Other longer-run behavioral changes might include the reduced use of unproductive tax shelters and reduced tax evasion in response to lower marginal tax rates. These effects may well result in greater economic efficiency, and possibly in more revenue than static estimates would indicate.

Distributional Neutrality

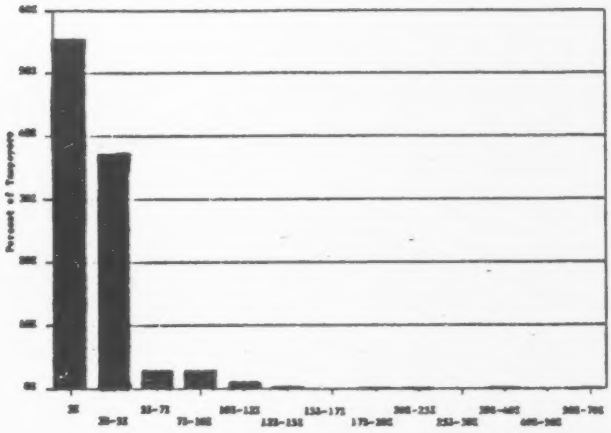
Concerns about the distribution of tax liabilities have led sponsors of tax reform to structure their proposals so as to limit changes in the tax burdens among different income groups. The Bradley-Gephardt proposal is described as roughly matching the existing tax distribution for all income groups; the Kemp-Kasten plan, as keeping liabilities of those with incomes up to $100,000 about the same as under current law.

The Kemp-Kasten plan would be more favorable than both current law and the Bradley-Gephardt plan for taxpayers with capital income. The full indexing of capital gains, full offset for capital losses, the retention of ACRS, and lower tax rates should significantly reduce taxes on capital income. Because capital income accrues primarily to upper-income taxpayers, the Kemp-Kasten plan could result in a lower relative tax burden on high-income groups.

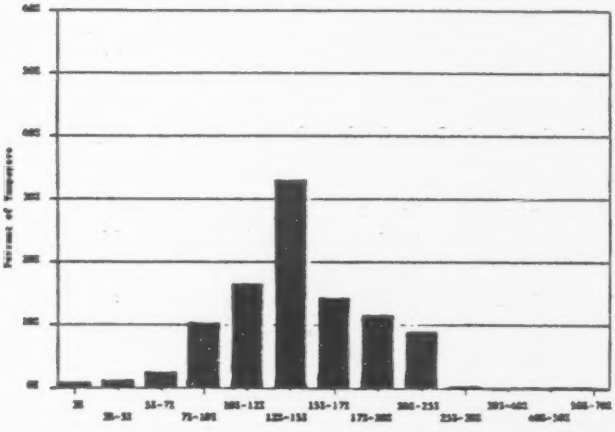
Because taxpayers' usage of tax preferences varies greatly within each income group, redistribution of tax burdens within income classes would occur across the income scale under both tax plans. Calculations using data from 1981 tax returns suggest the extent to which a wide-scale redistribution of tax liabilities among taxpayers with apparently similar incomes would occur. Figure 1 shows the distributions of average tax rates among taxpayers in several representative income groups. The rates used are the ratio of taxes paid to adjusted gross income (AGI). AGI, the taxpayer's measure of income before exemptions and deductions, does not adequately measure true economic income. It excludes tax-exempt income sources, such as contributions to qualified retirement plans, 60 percent of capital gains, and tax-free fringe benefits; its measure of depreciation does not match economic depreciation. AGI, as defined above, has been used here only because better measures are not available. Tax reform proposals such as the Bradley-Gephardt and the Kemp-Kasten plans would significantly change the definition of AGI.

Within each group shown in Figure 1, taxpayers with lower-than-average rates have been able to make greater use of current tax preferences than have others; these taxpayers face a greater probability of higher taxes under either reform proposal. By contrast, those in the upper ends of these distributions take relatively little advantage of tax benefits and so are certain to gain from tax rate reductions. A significant range in average rates would obtain if broader measures of income were used.

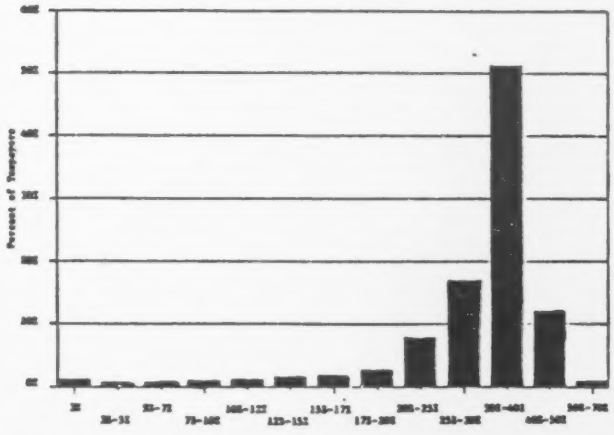
FIGURE 1. DISTRIBUTION OF AVERAGE TAX RATES IN SELECTED INCOME GROUPS, 1981



Adjusted Gross Income
Under $5,000



Adjusted Gross Income
$20,000 - $30,000



Adjusted Gross Income
$100,000 - $500,000

SOURCE: Congressional Budget Office using data from Internal Revenue Service, Statistics of Income--1981, Individual Income Tax Returns (1983).

Payroll Taxes and Benefit Programs

Apart from any potential increase in the wage share of compensation, Social Security and other employment tax collections could be affected by widening the definition of taxable compensation to include currently untaxed fringe benefits.

In theory, tax reform legislation could treat currently tax-exempt fringe benefits differently in the income tax and the social insurance tax bases. An example of this treatment exists in current law. Section 401(k) exempts income credited to cash or deferred compensation plans from income taxes but requires payment of payroll taxes. This kind of asymmetry, though, would not be in keeping with one of the primary goals of the tax reform agenda--simplification--since different provisions would be necessary for various fringe benefits as they apply to different taxes. In fact, the Bradley-Gephardt plan would include employer payments for life and health insurance and some disability compensation in the Social Security tax base. This would generate higher payroll tax revenues. Interaction between income taxes and payroll taxes will undoubtedly be explored in the discussion of tax reform.

Both the Kemp-Kasten and the Bradley-Gephardt plans increase the amount of income of low-income households that escapes taxation. Both would create a taxpaying threshold above the last official measure of the poverty line ($10,178 for a family of four in 1983).10/ These higher thresholds also reduce the likelihood that high benefit-reduction rates contained in various federally sponsored income-security programs will interact with the income tax to deter individuals from seeking employment.

Fairness and Simplicity

Both the Bradley-Gephardt and Kemp-Kasten bills should ease public concerns about the variety of tax breaks currently offered in the tax code and, to a more limited degree, about high marginal tax rates. The two proposals would eliminate many widely used tax preferences and lower the marginal rates for many taxpayers. By raising the taxpaying threshold, the two bills would also remove a large number of lower-income persons from the tax rolls. According to one estimate, for example, under the Kemp-Kasten plan, roughly 1.4 million current taxpayers would no longer be required to file.

Certain provisions in both bills would bring new complications. For example, the Bradley-Gephardt plan would require that most fringe benefits be included as part of reportable income. In practice, the valuation of certain nonmonetary benefits may be very difficult. An especially difficult case would be the valuation of health insurance premiums when an employer is "self-insured." Similarly, the phase-out of Kemp-Kasten's employment income exclusion and its indexing of capital gains and losses could be cumbersome for many individual taxpayers.

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10. Department of Commerce, Bureau of the Census, Money Income and Poverty Status of Families and Persons in the United States: 1983 (August 1984).

The Tax Structure

High marginal tax rates such as those of the current tax system are generally believed to discourage productive activities: work, saving, and investment. The narrowed tax base has required high marginal rates to raise sufficient revenues. Other problems associated with such a graduated rate structure include "bracket creep," the movement of taxpayers into higher brackets and the raising of their real tax burden as a result of inflation, and a "marriage penalty," the additional tax paid by many two-earner married couples.

Both the Bradley-Gephardt and the Kemp-Kasten plans would help alleviate these problems. The Bradley-Gephardt plan, however, is not indexed for inflation. The highest marginal rate under each plan would be roughly 60 percent of the highest rate under current law (50 percent). Lower marginal rates should reduce tax disincentives. A flatter rate structure would also reduce any differences in tax liabilities because of marital status.

Saving and Investing

Both plans would significantly alter the relative taxation of different forms of capital income, though the extent cannot yet be calculated. The Bradley-Gephardt plan, however, could raise overall taxation of capital income because of the elimination of ACRS and the full taxation of capital gains on an unindexed basis, especially if inflation increases.

Because of the very different tax treatment of capital income under the two proposals and the difficulty of estimating the savings response to (even less-sweeping) tax changes, it is not possible now to measure and compare accurately the effects of the two proposals on national savings. However, the lower marginal tax rates should reduce disincentives to save. Perhaps more important, the greater uniformity of tax rates on different assets in both plans should mean that any given supply of savings is used with greater efficiency.

Transition to a New Tax System

Neither plan discussed here includes complete rules for transition from current law. Such rules are likely to be quite complex. The transition to a new system would also create immediate gains and losses. Those could take the form of sharp declines in the value of some assets that are now lightly taxed, and increases in the value of currently heavily taxed assets. Although transitory gains and losses would occur, the economy would almost certainly experience long-term gains in efficiency and growth.